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EX PARTE

Ms. Donna R. Searcy
Secretary
Federal Communications Commission
1919 M Street, N.W., Room 222
Washington, D.C. 20554

RE: CC Docket No. 92-101

Dear Ms. Searcy:

In CC Docket No. 92-101, the Ad Hoc Telecommunications Users Committee (Ad Hoc) submitted an ex parte presentation on June 9, 1992, to include in the record a report prepared by the California Public Utilities Commission's Division of Ratepayer Advocates (DRA) regarding the state ratemaking impacts of adoption of Statement of Financial Accounting Standards 106 (SFAS 106). This report was filed by DRA in California's proceedings to determine the appropriate accounting and ratemaking treatment for postretirement benefits other than pensions.

At the outset, it should be noted that DRA is a branch of the California Public Utilities Commission (CPUC) that was created to represent ratepayer interests in matters before the CPUC. It would, therefore, be incorrect to assume that DRA's report represents the views of either the CPUC or the CPUC staff.

The DRA report is not germane to this Commission's investigation into the proposed price cap adjustment for OPEBs. For the most part, the report is devoted to issues that have already been settled by this Commission. For example, DRA recommends that the CPUC ignore accrual accounting in favor of pay-as-you-go accounting. The FCC has already adopted SFAS 106 accounting. Likewise, DRA argues against recovery of all OPEB funding in California. The FCC has already granted recovery of OPEB VEBA funding for some carriers (Order in CC Docket No. 90-320, released June 21, 1990).

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Much of DRA's report is irrelevant because of the differences between CPUC and FCC ratemaking. For example, DRA struggles with revenue requirement issues related to the CPUC's flow-through method of accounting for income taxes. This Commission recognizes income taxes on an accrual accounting basis. Also, DRA examines exogenous treatment of OPEB based on its own highly questionable interpretation of CPUC rules, not FCC rules.

Finally, the report does not address the issues designated for investigation by the Order of Investigation and Suspension, DA 92-540, released April 30, 1992:

1. Have the LECs borne their burden of demonstrating that implementation of SFAS 106 results in an exogenous cost change under the Commission's price cap rules?

2. If these cost changes are treated as exogenous,

    a) Should costs associated with implementation of SFAS 106 prior to January 1, 1993 (when the accounting change becomes mandatory) be treated as exogenous?

    b) Are the assumptions made by the individual LECs in calculating these costs reasonable?

    c) Given these assumptions, have the individual LECs correctly computed the exogenous cost changes?

    d) Are the individual LEC allocations of these rates among the price cap baskets consistent with Commission rules?

For all of the reasons stated above, the Pacific Companies believe that the Commission should place no weight on the DRA report.

Numerous parties (including gas and electric utilities) filed rebuttal testimony opposing the positions taken by DRA in its report. Therefore, it would be inappropriate for the Commission to draw any conclusions based on the DRA report in isolation. A thorough review of all testimony and transcripts presented before the CPUC would be required to analyze the issues presented in the DRA report. The CPUC is still rendering its decision on this matter. However, so the DRA report does not stand unopposed, the Pacific Companies hereby submit a copy of Pacific Bell's rebuttal testimony to the DRA report for inclusion in the record in CC Docket No. 92-101.

In accordance with Section 1.1206(a)(1) of the Commission's rules, enclosed are an additional two copies of this letter with the appropriate enclosures. Please contact me if you have any questions concerning this matter.

Respectfully submitted,

Sherry Herauf

Enclosure
cc: Mary L. Brown

Daniel J. McCarthy
Senior Counsel

Legal Department
140 New Montgomery Street
San Francisco, California 94105
(415) 542 7547

PACIFIC BELL
A Pacific Telesis Company

January 21, 1992

The Honorable Michael J. Galvin
Administrative Law Judge
California Public Utilities Commission
505 Van Ness Avenue, Room 5018
San Francisco, CA 94102

Dear Judge Galvin:

Re: <u>I.90-07-037 and Related Proceedings</u>

In accordance with your ruling during hearings on December 3, 1991, enclosed are the following:

1. Rebuttal Testimony of Dennis W. Evans, with attachments, dated January 21, 1992;

2. Rebuttal Testimony of Phillip J. Lauro, dated January 21, 1992; and

3. Rebuttal Testimony of Dr. William E. Taylor, with attachments, dated January 21, 1992.

Sincerely,

Attachments

cc: All Parties to I.90-07-037 and Related Matters

BEFORE THE PUBLIC UTILITIES COMMISSION OF THE STATE OF CALIFORNIA

Investigation on the Commission's own motion into the matter of post-retirement benefits other than pensions.	I.90-07-037 (Filed July 18, 1990)
Application of Pacific Gas and Electric Company for authority among other things, to increase its rates and charges for electric and gas service. (Electric and Gas) (U-39-M)	Application 88-12-005 (Filed December 5, 1988)
And Related Matter.	I.89-03-033 (Filed March 20, 1989)

REBUTTAL TESTIMONY OF DR. WILLIAM E. TAYLOR

ON BEHALF OF PACIFIC BELL (U 1001 C)

January 21, 1992

REBUTTAL TESTIMONY OF DR. WILLIAM E. TAYLOR

I.90-07-037

1. Q. Please state your name and business address.

   A. My name is William E. Taylor, and my business address is One Main Street, Cambridge, MA 02142.

2. Q. Did you previously submit testimony on November 15, 1991?

   A. Yes.

3. Q. What is the purpose of your rebuttal testimony?

   A. The purpose of my rebuttal testimony is to respond to portions of the Testimony first raised by the Division of Ratepayer Advocates ("DRA") in their Phase II Testimony titled "Report on Statement of Financial Accounting Standards No. 106" ("Report"), dated November 15, 1991.

4. Q. Please generally describe your rebuttal testimony.

   A. The DRA alleges that pay-as-you-go funding is both cost-effective and sound regulatory accounting treatment for PBOPs (Report, p. 4). Furthermore, the DRA asserts "economics clearly dictate that pay-as-you-go is the most efficient approach and provides the most benefits to ratepayers (Report, p.

20). The DRA's underlying rationale for its position as to whether FAS 106 should be adopted for Pacific for ratemaking purposes and the DRA's rationale for treating the associated revenue requirement are basically flawed. In the attached, "The Treatment of FAS 106 Accounting Changes Under Pacific Bell's Price Regulation Plan: Economic Analyses of DRA's Testimony", I reply to the major errors presented in the DRA's November 15, 1991 testimony.

5. Q. Does this conclude your testimony?

A. Yes.

THE TREATMENT OF FAS 106 ACCOUNTING CHANGES UNDER PACIFIC BELL'S PRICE REGULATION PLAN: ECONOMIC ANALYSIS OF THE DRA SUPPLEMENTAL TESTIMONY

Prepared for

Pacific Bell

National Economic Research Associates, Inc.
One Main Street
Cambridge, Massachusetts 02142

William E. Taylor and Timothy J. Tardiff
Study Directors

January 21, 1992

n/e/r/a

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THE TREATMENT OF FAS 106 ACCOUNTING CHANGES UNDER PACIFIC BELL'S PRICE REGULATION PLAN: ECONOMIC ANALYSIS OF THE DRA TESTIMONY

The purpose of this report is to analyze economic issues now raised by the Department of Ratepayer Advocates (DRA) in its Supplemental Testimony.[1] The major issues are whether FAS 106 should be adopted by the Commission for ratemaking purposes and, if so, what the appropriate treatment of the associated revenue requirement changes would be under the California price cap plan.

I. PACIFIC BELL HAS PRESENTED A COMPLETE JUSTIFICATION FOR Z-FACTOR TREATMENT OF THE FAS 106 ACCOUNTING CHANGE

In its August 30 and November 15, 1991 filings, Pacific Bell presented a proposal for the Z-factor treatment of the FAS 106 accounting change for Postretirement Benefits Other than Pensions (PBOPs) as directed by the Commission in its OII and Decision 91-07-006 (Phase I Decision). This proposal quantified the changes necessary (i) to recover amounts prefunded prior to January 1, 1993, and (ii) to base rates on accrual accounting for PBOP expenses on a going-forward basis. It explained the economic basis for treating the difference in revenue requirements under cash and accrual accounting as an exogenous cost change (a Z-factor adjustment) in Pacific's New Regulatory Framework (NRF) established in Docket 89-10-031. Finally,

[1]Division of Ratepayer Advocates, "Report on Statement of Financial Accounting Standards No. 106, Phase II Testimony," (Supplemental Testimony), November 15, 1991.

it quantified the change in the national inflation rate due to the adoption of FAS 106 and calculated the price change remaining to be implemented through a Z-factor adjustment.

In its Supplemental Testimony, the DRA reached several economic conclusions, which they summarized on pages 76-77. First, it determined that FAS 106 should not be adopted for ratemaking purposes because, in its view, "PAYGO is the most cost-effective option for funding PBOPs obligation." Second, it concluded that FAS 106 should not be used to set rates because "the liability computed under SFAS 106 is not legally binding, does not reflect an employer's funding obligation, and can be changed at the discretion of management," and because "SFAS 106 will have (no) effect on the utilities' cash flow or creditworthiness." Third, in the event that FAS 106 is adopted for ratemaking purposes, it proposed to implement a series of "monitoring, tracking, and regulatory procedures". Finally, the DRA proposed that "Pacific and GTE ...recieve (sic) no increases in rates for PBOPs," because they "simply have not met their burden of proof to show that PBOPs costs are beyond their control." In this report, we show that the DRA's economic analysis does not support its conclusions.

A. Pacific Bell's proposal

Pacific Bell proposed to adopt FAS 106 accounting for ratemaking purposes through a one-time Z-adjustment to its price cap to reflect (i) the amortization over 20 years of the historical liability for PBOPs and (ii) the shift from cash to accrual accounting on a going-forward basis. No further changes in PBOP expenses would be permitted to affect Pacific's price cap, except that there would be an offsetting Z-adjustment after 20 years when the historical liability is entirely amortized.

B. <u>Economic basis for the proposal</u>

The single most critical economic fact in this case is that the expenses recognized under accrual accounting for PBOPs are consistent with economic costs, while PBOP costs recognized under cash accounting are not.[2] Two important consequences follow from this fact. First, in unregulated markets, prices already reflect the economic costs of PBOPs, and the change from cash to accrual accounting will have no effect on prices in those markets. Second, in regulated markets where prices are based on accounting costs, prices have not reflected accrual accounting for PBOPs and thus have not reflected economic costs for services. If adopted for ratemaking purposes, the change from cash to accrual accounting in these markets would move prices towards economic costs and would remove the intergenerational inequities embodied in the current price structure.

Pacific Bell's proposed Z-adjustment is exactly the type of adjustment contemplated by the NRF. The purpose of exogenous cost changes in the price cap process is to pass through changes in costs into prices so that prices are more closely aligned with costs over time, so long as the cost changes in question are beyond the

[2]The reason is that accrual accounting for PBOPs estimates the present value of the liability that will be incurred because a worker is employed for a given year. To measure the labor component of incremental cost (for a service), one would calculate the increase in person-hours (for different types of labor) caused by a hypothetical increase in demand. Each additional person-hour would add to the total cost of the firm, an amount equal to the sum of wages and benefits. The cost of additional benefits to the firm caused by the additional person-hour is the present value of the liability that the firm expects to incur at some later date, and that present value is the cost estimated by accrual accounting methods.

control of the firm.[3] The first requirement is satisfied: Pacific Bell's proposal to base a single Z-adjustment on the difference in revenue requirements under cash and accrual accounting will effectively align rates under the NRF with their economic costs for PBOPs. But in what sense are PBOP expenses beyond the control of the firm?[4]

On-going PBOP expenses are not beyond the control of the firm. They are an element of the compensation package for workers, and Pacific Bell has roughly the same ability to raise or lower on-going PBOP expenses as it does to raise or lower wages.[5] What are beyond the control of the firm are (i) the proposed change in accounting standards, and (ii) the build-up of an historical liability that has resulted from cash accounting in the past. Changes in accounting standards clearly have nothing to do with Pacific Bell management, and no current decision of Pacific Bell can affect the historical liability for PBOPs already earned by its employees in the past. On a going-forward basis, PBOP expenses are under management control, and it would be inappropriate to flow through annual changes in PBOP expenses as a Z-adjustment. But that is not what Pacific Bell is proposing to do. Rather, Pacific proposes a one-time change in the price cap to align rates and costs as if the NRF had been implemented with prices set by accrual accounting for PBOPs. That one-time change adjusts for the fact (recognized exogenously in FAS 106) that the prices

[3]Such price changes increase static economic efficiency (by moving prices towards economic costs) while not reducing dynamic efficiency because the firm's incentives are not distorted by passing through costs over which the firm has no control.

[4]Indeed, the DRA (Supplemental Testimony, p. 68) points out that "PBOP costs will always remain completely under management's control," and that "the Commission should look at PBOP costs just like any other labor costs under NRF..." Both of these statements are correct.

[5]This ability is, of course, not unlimited. Pacific hires workers in competitive labor markets, and changes in PBOP benefits affect its ability to attract and maintain its workforce.

under which the NRF began did not reflect the true economic cost of PBOPs offered to workers up until that time. Thus adoption of FAS 106 would align accounting costs and economic costs, and Pacific's proposed Z-adjustment would align the initial NRF prices with economic costs.

With initial NRF rates set at their appropriate level, Pacific Bell's management would then have the incentive to manage PBOP expenses in the same manner as all other costs. All else equal, if PBOP costs declined, Pacific Bell's earnings would increase, and if PBOP costs increased, Pacific Bell's earnings would fall. These are the same incentives faced by firms in unregulated markets which compensate workers with similar packages of wages, pensions, and PBOPs.

C. <u>The DRA's Supplemental Testimony does not address the key economic features of Pacific Bell's proposal</u>

The economic logic behind Pacific Bell's proposed Z-factor treatment of FAS 106 accounting changes is based on the following facts:

(1) Accrual accounting for PBOPs recognizes economic costs of PBOPs; cash accounting (PAYGO) does not.

(2) Prices in regulated markets are based on accounting costs with cash accounting for PBOPs. Current prices reflect PBOP costs for services rendered at some time in the past. Current prices will have to change to reflect economic costs of PBOPs earned in the provision of current services.

(3) Recognition of the actual liability for <u>past</u> PBOPs is beyond the control of the firm.

(4) Prices in unregulated markets already reflect the economic costs of PBOPs so that adoption of FAS 106 will not cause them to change.

The DRA Supplemental Testimony does not claim (or show) that PBOP expenses recognized by cash accounting (PAYGO) procedures represent economic costs. Thus it is silent on the critical question: Are current prices set at the proper level to reflect economic costs of providing current services? Nor does the DRA Testimony address the exogeneity of an accounting change to recognize the cost of PBOPs earned by workers in the past. In appraising the relative merits of cash and accrual accounting for PBOPs, the Supplemental Testimony confines itself to the observation that--for certain periods of time and under certain conditions--ratepayer bills would be less under cash accounting than under accrual accounting. Its discussion of exogeneity is confined to the correct (but irrelevant) observation that changes in on-going PBOP expenses cannot be treated as exogenous because they are under the control of the firm.

The DRA testimony correctly concludes that FAS 106 will have no effect on prices in unregulated markets: on pp. 36-37, the DRA cites studies in Appendix 5 that show adoption of FAS 106 will have no perceptible effects on U.S. markets. However, the DRA interprets this observation to mean that SFAS 106 "has not been embraced by the corporate, financial, and legal communities as the true measure of an employer's PBOP costs." The opposite interpretation is the correct one. It is not reasonable to believe that the economic costs of PBOPs for firms in competitive markets have been ignored for pricing and other management decisions. Accrual accounting for PBOPs (approximating economic costs) had been effectively embraced for all economic decision-making (including pricing) in the unregulated sector long before FAS 106 was contemplated. Hence adoption of FAS 106 would have no effect on prices in these markets because their prices already reflect accrual accounting for PBOPs.

Finally, regarding the effect of FAS 106 on rates in regulated markets, the DRA is silent on the question of inter-generation inequities. The Commission's Phase I decision identified the problem as:

> "...current ratepayers do not pay for PBOPs benefits being earned by the utilities' employees while serving the ratepayers. Rather, they pay only those PBOPs benefits to utilities' employees who earned their benefits in a prior time period. This results in an inter-generation inequity," (p. 17)

An important theoretical benefit from accrual accounting for PBOPs is the elimination of this inequity. Recognizing accrual accounting for PBOPs--while failing to adjust rates--will not resolve this problem.

II. ECONOMIC THEORY SUPPORTS PACIFIC BELL'S PROPOSAL

A one-time Z adjustment which reflects

(i) the amortization of the embedded PBOP liability over 20 years, and

(ii) accrual accounting for ongoing PBOP expenses

is necessary to move prices towards economic costs. Passing the change in accounting costs through to prices will remove current distortions in the labor and telecommunications markets and eliminate the problem of intergenerational inequities from cash accounting for PBOP expenses.

A. Utility prices should reflect economic costs

There is general agreement among economists and regulators that public utility prices should be based, to the extent possible, on economic costs. To an economist, such prices are desirable because they increase economic efficiency. To a regulator, cost-based prices tend to be just and reasonable because they insure that each customer pays his or her own way, in the sense of paying at least as much for additional service as it costs to produce. Previous Commission actions in California (e.g., expensing station connections, workers compensation, and movement towards economic depreciation rates) and in the Federal jurisdiction (e.g., the transition towards flat-rate recovery of interstate non-traffic sensitive costs) are consistent with this pricing objective.

In addition, moving current prices towards current costs reduces the intergenerational inequity discussed in the Phase I decision. This inequity comes about through regulatory practices that inappropriately defer cost recovery into the future, reducing current prices below current economic costs while raising future prices above future economic costs. Such practices include cash accounting (PAYGO) for pensions or PBOPs, and the use of overly long depreciation lives instead of economic depreciation lives for capital recovery. Such prices are inequitable because future ratepayers are burdened with the costs of services consumed by current ratepayers. They are also inefficient because at no point in time do ratepayers face proper incentives for choosing among services and because utilities face different constraints in the provision of PBOPs than unregulated firms.

Under both California and Federal price cap plans, the initial rates are taken to be just and reasonable. In the California Phase II Order, the Commission observed that

> "(a)n integral part of this mechanism is the assumption that the rates to which the index is applied form a reasonable starting point for determining rates for the upcoming year." (p. 295).

The FCC made a similar assumption in its Second Report and Order, CC Docket 87-313, (October 4, 1990):

> "...LEC interstate access rates, as they existed on July 1, 1990 and were adjusted by an Erratum, [footnote deleted] are the most reasonable basis from which to launch a system of price cap regulation" p. 97.

These initial rates, based directly or indirectly on accounting costs for the regulated firm, embody cash accounting for PBOPs as it was experienced before price caps were instituted. Thus, these initial rates must be adjusted to align prices under price caps with economic costs.

B. Accrual accounting costs for PBOPs are economic costs

The economic costs of hiring an additional worker are given by the sum of wages paid and the present value of expected pension and PBOP expenses for that worker. PBOP expenses under cash accounting for a given year are irrelevant to a manager trying to decide how many workers to hire because expenses for PBOPs under cash accounting are determined by the medical, dental, and legal experiences of people who are not currently working. In unregulated markets, managers hire workers until the value of the additional output of the last worker just equals the additional cost incurred by hiring the worker. The compensation package for a worker includes wages, pensions, and PBOPs, and competitive pressures prevent managers from treating the costs of pensions and PBOPs as anything other than the present value of the expected cost of that benefit.

C. **Prices in unregulated markets reflect accrual accounting for PBOPs**

On page 20, the DRA states it "only seeks to ensure that the adopted funding and accounting truly reflect how PBOPs are provided...." Accrual accounting accomplishes this objective; in fact, prices in unregulated markets already reflect accrual accounting.

There is abundant evidence that shifts in accounting standards have negligible effects on firms in competitive markets. Our previous study reported a search of the empirical literature examining the effects of the 1987 FASB change in the method of accrual accounting for pension benefits. The search revealed no evidence linking stock prices and pension accounting changes.[6] In Appendix 5 to its Supplemental Testimony, the DRA presented copies of

> " various publications that explain the impact of SFAS No. 106 on corporate financial status and that report the actual (non)impact of SFAS No. 106 on major corporations that have already adopted SFAS No. 106 for reporting purposes," (p. 37).

Thus in unregulated markets, these additional PBOP costs have been recognized by the corporations in prices and by financial analysts as a liability of the firm. The accounting recognition of these costs, therefore, has no impact on the financial situation of the firms.

[6]W.E. Taylor and T.J. Tardiff, "The Effect of FAS 106 Accounting Changes on Pacific Bell's Price Regulation Plan," California Docket I.90-07-037, August 30, 1991, p. 22.

This point is also made in the DRA's (correct) conclusion that changes in accounting costs--even for regulated firms--have no connection with changes in economic costs:

> "Though the change in "accounting" costs is significant when compared to the LEC's other accounting entries, there are no significant changes to the utilities' economic costs." (p. 70).

Accounting costs, however, have determined prices for regulated firms, from which we conclude that PBOP expenses are currently (before adoption of FAS 106) treated differently for pricing decisions by managers of regulated and unregulated firms.

D. Continued cash accounting for PBOPs distorts competition in labor and telecommunications services markets

Regulated and unregulated firms compete for workers in the labor market, and with prices set by cash accounting for PBOPs, regulated firms experience different incentives to offer wages, pensions, and PBOPs to workers than the incentives facing unregulated firms. With competition for telecommunications services, the consequences of this distortion are even greater. Price limits in Pacific Bell's competitive markets today are set through a price cap formula whose starting point was based on cash accounting costs for PBOPs. Competitors' prices are determined by their economic costs which include PBOP costs as measured by accrual accounting.[7] As California

[7]This phrase should not be taken to imply that Pacific Bell's competitors will quickly move to fund PBOPs or to change their prices when they change their accounting. In competitive markets, prices are set by the market and are driven towards economic cost. Irrespective of accounting conventions, economic forces will drive the firm's prices towards a level consistent with accrual accounting for PBOPs.

moves towards a more competitive intraLATA telecommunications environment, it is essential that regulatory distortions in pricing be removed.

E. The DRA's argument confuses economic costs, legal obligations, and funding decisions that are unrelated

The DRA expresses concerns about the "the uncertainties associated with PBOPs and the inaccuracies and volatility associated with SFAS No. 106" (p. 30). These concerns have no bearing on the fundamental economics of PBOP costs.

The DRA observes on p. 11 and pp. 36-37 that the provision of PBOPs is (in some sense) not necessarily binding and does not entail a funding obligation. From these facts, they conclude on p. 36 that

- "it is obviously unfair and unreasonable to burden ratepayers with expenditures for "obligations" that are not legally enforceable,"
- "because the assets are not vested [footnote omitted], individual employees do not have a legal right to obtain them... Improvements in employee morale and productivity will not materialize because the individuals who have earned these benefits will soon find that...they are not entitled to them," and
- "employers will soon find that since these PBOPs fundings are earmarked for benefits, not employees...prefunding will create disincentives for pursuing health cost containment."

Economic costs for PBOPs are primarily determined in the labor market. Workers' attitude towards risk and their tax preferences determine the relative attractiveness of compensation packages containing different mixtures of wages, pensions, and PBOPs. Whether or not a PBOP is enforceable, the firm that offers a PBOP to a worker incurs an expected stream of future liabilities. The size of that expected stream depends on the details of the plan, and assumptions about future obligations under the plan must be made to quantify the expected cost of the PBOP. Such calculations were performed in Pacific Bell's filing to determine the difference in the revenue requirements under cash and accrual accounting for PBOPs. Such calculations are implicitly made every day in unregulated markets where firms hire workers and offer compensation packages including wages and PBOPs.

Whether or not a PBOP is funded is irrelevant in determining its economic cost. The cost of a PBOP is the present value of the expected future liability. Funding a PBOP is a financial decision concerning the best way to cover that cost.

The above quotations cite two perverse incentive effects because PBOPs are not vested with individual employees: (1) morale and productivity will not rise, and (2) firms will have no incentive to pursue medical cost containment. First, Pacific Bell competes in labor markets with many other firms. Employees seem to prefer PBOPs in their compensation package. Otherwise, Pacific--and other companies--would no longer find it competitively advantageous to offer them. Second, under the NRF, Pacific Bell has every incentive to contain medical costs. Under Pacific Bell's proposed plan, a one-time Z-adjustment would be made to reflect the difference in revenue requirements between cash and accrual accounting for PBOPs. From that day forward, every additional dollar Pacific spends in health cost expenditures directly reduces earnings, just as with cash accounting for PBOPs under the NRF. The fact that PBOPs are not vested has no effect on Pacific Bell's incentives to contain health costs.

III. PRICE CAP THEORY

The DRA asserts that for a cost change to be passed through to the price cap as Z-factor adjustment, five criteria must be met and that Pacific has not met the burden of proof that these requirements have been satisfied (pp. 66-77). We respectfully disagree.

A. Management control over costs

As pointed out by the DRA, the Commission states in D.91-07-006 that

> "to be considered for a Z factor treatment, costs must...be clearly beyond the utility's control." (D.89-10-031, p. 180)

On page 66, the DRA claims that "neither utility addressed in any substantive way the issue of whether PBOPs costs are beyond their control. This lack of showing is in itself sufficient reason for the Commission to deny Z factor treatment..." Continuing, the DRA makes the obvious point that on-going PBOP expenses are very much under management control, just as wage levels are under management control.[8] However, this fact has nothing to do with whether or not the change in costs proposed by Pacific Bell for Z-factor treatment is beyond the utility's control. Pacific Bell is not proposing that annual changes in its PBOP costs (however measured) be treated as a Z-factor. If it did, the DRA's argument on pp. 66-67 would correctly show that PBOP expenses can be controlled (like any labor cost) by changes in the plan and by efforts to contain health costs.

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[8] "Indeed, the Commission should look at PBOPs costs just like any other labor costs under NRF...", Supplemental Testimony, p. 68.

The change in costs that Pacific Bell is proposing for Z-factor treatment is the one-time change in PBOP costs caused by the adoption of FAS 106. Although the DRA is silent on the subject, the FAS 106 standards, if adopted by the Commission, are clearly outside the control of regulated utilities. Such accounting changes were explicitly identified as possible Z-factor adjustments in the Phase II decision.

The bulk of the cost change is due to the 20 year amortization of the historical PBOP liability, and that cost is beyond the utility's control, in the sense that it has already been incurred. The costs that Pacific Bell can control are PBOP expenses on a going-forward basis, and this fact is recognized in its proposal for Z-factor treatment. The one-time Z-factor adjustment proposed by Pacific would set its prices at the level they would have been had Pacific begun the NRF under accrual accounting for PBOPs.

B. The cost change must be disproportionate

In the first place, there is some repetition among the DRA's five requirements. A reading of the Commission's Orders shows that the reason the effect of the change must impact Pacific Bell disproportionately is so that there is no double recovery of the FAS 106 effect through the Z-factor and the rate of inflation.

That said, DRA asserts on p. 69 that

> "the cost increases associated with SFAS No. 106...are not economic in nature. Rather, they reflect accounting entries for costs and obligations which already existed at the time of NRF, and which will be eventually paid one way or another."